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ANALYSIS OF THE 2003 MAJOR BUDGET POLICY GUIDELINES

Discontinuation of Planning Protected Expenditure Items

In the 2003 Major Budget Policy Guidelines proposed by the Government, it was suggested to discontinue planning of protected expenditure items. The reasoning was that "a balanced budget must be executed in all types of spending in the full amount." The Fiscal Analysis Office presents here our views on this matter and a discussion of international practice with respect to protected expenditures.

PRO discontinuation

- Selective protection of expenditure items is not in full accord with the principle of program budgeting. In a program budget, decisions on financing (or discontinuation of financing) must be made based on the achieved outcomes rather than on the need in invested resources (such as wages).
- The task of establishing social priorities is very difficult. Protection of one expenditure program always must allow for a "zero-base" principle for financing of other, "non-protected" items, and hence it always involves a difficult political choice.
- The majority of arguments against the use of "protected" expenditures deal mainly with criticism of the existing list (its contents or size) rather than with protection as such.

CONTRA discontinuation

- Protected expenditures allow accounting for uncertainty in budget execution which is always present.
- This instrument is especially important in transition and in other crisis situations, including the eve of a tax reform.
- "Protection" of some expenditures allows to retain political and economic soundness in situations of an unforeseen reduction of revenues.
- "Protection" of some expenditures supports established social priorities.
- "Protection" of budget expenditures is a common practice in budget systems of developed and sustainable economies.
- The list (contents) of budget items is specific and any imperfection should not discredit the idea of protection as such.
- "Protection" of expenditures is an instrument explicitly provided for in the Budget Code.
- The government's argument to discontinue of protected items appears to be not quite logical.

The instrument of "protection" of specific expenditures is a defender in terms of budget uncertainty

Legislative provisions pertaining to "protection" of specific budget expenditures at the stage of planning is an instrument of budget policy which is applied in many economies, both transitional and developed. These "protective" mechanisms can be implemented either in particular legislative acts or in the form of annual budget law. Be that as it may, however, their main purpose is to establish a procedure to meet cases where budget resources are insufficient for the State to fulfil all its budget commitments. First of all, such a situation may arise where, in the process of budget execution, actual revenues are smaller than forecasted at the stage of planning. Conceptually, however, some other situations are also possible, for instance: the State has to finance unexpected expenditures and, revenue forecasts being unchanged, has to do this at the cost of other expenditure plans.

Currently, in the budget process of any country, regardless of the level of its economic development, there remains some element of uncertainty. Even if the most professional and sophisticated approach is applied to revenue forecasting, estimated figures are always no more than a forecast whose realization depends on a number of various factors of a macroeconomic, political, and foreign-economic nature. The expenditure side of any budget also is always open to some risks. Even where a country's legislation disallows opening new expenditure programs in the course of a budget cycle, an extraordinary situation (such as natural calamities) may force the State to increase certain expenditures.

One possible example of a situation where even a developed economy may suddenly face a problem of unexpected underexecution of budget revenues is the current position of the USA's local budgets. In the majority of US states, actual budget revenues are at a level much lower than that planned for this fiscal year. In the late 90's, most of these states had excellent revenue performance and were able to increase the expenditure side of the budget and reduce the tax pressure on local citizens; many states were even able to create a considerable surplus. Based on the first half-year report, the federal government executes central budget revenues in a fairly steady manner, despite the recent economic recession. At the same time, there are actual deficits at the local level, and since the majority of states are obliged to keep their budgets balanced, local governments have currently to search for ways to liquidate the deficit. This is done in many cases through cutting expenditures, despite the fact that sequestration is the most unpopular measure in a pre-election year.

At the same time, in the US federal budget, whose revenues are executed in a very stable manner (according to latest estimates, the surplus achieved at the central level in 2001 is the second largest in the USA's history – USD 158 billion), it is also intended to make sequestration of certain budget expenditures[1] based on results of the first half of the FY 2002[2]. This is related to the fact that the USA recently have enacted a new legislative act that requires implementation of new expenditure programs dealing with financing of roads and public transportation[3]. According to the Budget Enforcement Act[4], which regulates the USA's budget system, no one new expenditure is allowed to increase the resource need in the budget as a whole. Therefore, new transport-related expenditure programs will cost the US budget a USD 115 billion cut in other expenditures.

Since there is always a possibility that expenditures would have to be reduced at some point of the budget year, it is always reasonable to think through and set legislatively certain sequestration rules to be applied if needed. Another important question is how to allocate the responsibility for making such decisions between the legislative and executive branches of power? Amendments to current budgets (including those requiring a reduction of expenditures), which are typically initiated by the government, must be approved by the parliament, as a rule. The parliament, however, may impose some restrictions on the government's actions by way of adopting in advance a legislative act that regulates the sequestration procedures.

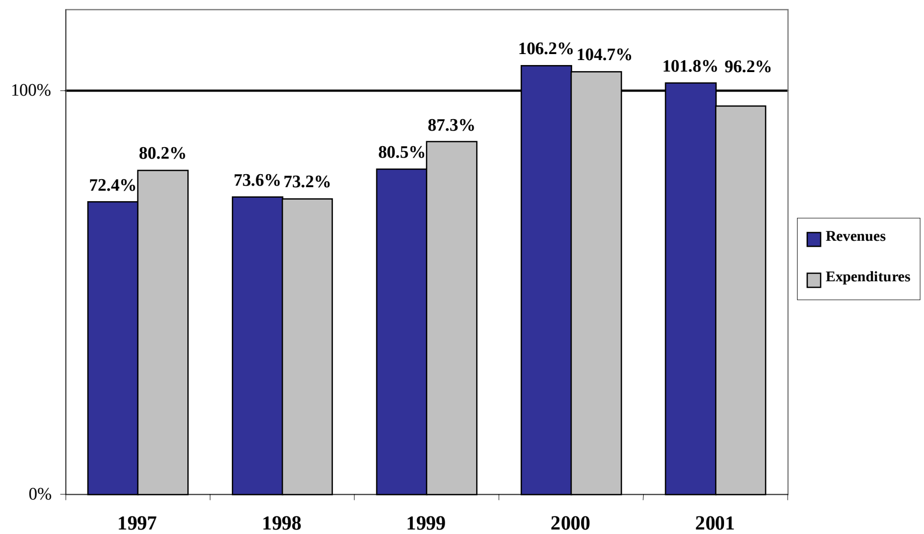
[1] So called 'spending limits or caps' are meant here, which comprise the expenditure side of the US budget.
[2] In the USA's budget system, a fiscal year begins on October 1 and lasts until September 30 of the next calendar year.
[3] *The Transportation Equity Act, (TEA-21).*
[4] *Budget Enforcement Act (BEA), 1997.*

Protected expenditures in Ukraine

For the first time, protected expenditures appeared in Ukraine in the 1998 State Budget Law. As one can see from a Graph below, State budget revenues were heavily underexecuted in those years. In 1997 revenues, except for privatization, were executed at the level of only 72.3% of the budget plan. In 1998-1999 this indicator was not much higher – 73.6% and 80.5% respectively. Only in the last two years, have actual revenues of the State budget reached the forecasted level, though, despite stability in revenues, the expenditure side experienced underfinancing.

Beginning in 1998, protected expenditures were imposed by way of relevant article in the State Budget Law for the year in question with a specific list of protected expenditures. Besides, in the budgets before 2002 the mechanism of "protection" of these expenditures was specified in this budget article.

State Budget Execution between 1997-2001*



* Figures of expenditures and revenues in this Graph are calculated with account for changes in the budget classification, which occurred in 1998 and 2002 and are in accord with the current structure of revenues and expenditures. Among other things, this means that budget revenues do not include privatization proceeds.

In recent years, this mechanism provided that "these expenditures shall be funded as a high priority and proportionally to specific spending units of relevant budgets". In 2002 the budget was for the first time formulated on the basis of the Budget Code, and this article contained only a list of protected items as there was no need in defining this notion as such because it was already defined by Article 55 of the Budget Code.

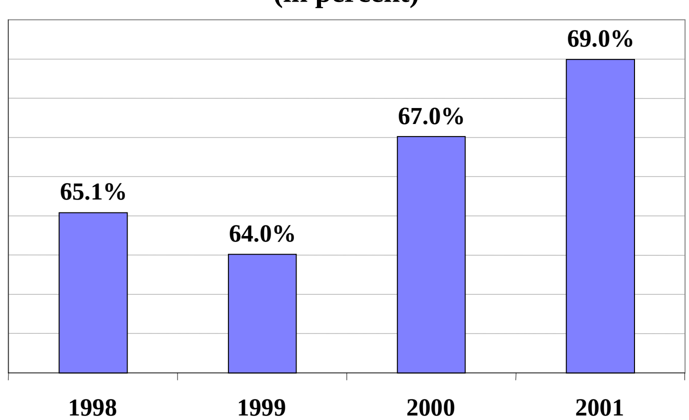
According to the Budget Code, protected expenditure items are those items of State budget spending and local budget spending, whose amounts shall not be changed when sequestering the approved budget appropriations. The specific list of such items, according to the Budget Code, shall be defined by the State Budget Law for the year. There is no explicit requirement in the Code to plan such items.

The list of protected items, which exist in Ukraine currently, has not been changed since 1998 to any significant extent. A Table below contains the list of these items and shows the history of its changes in recent years. As one can see from the Table, this list traditionally contains seven expenditure items of economic classification of budget expenditures. These include: wages of government employees; payroll taxes; purchase of medicines and dressing materials; nutrition; state debt servicing; as well as transfers to local budgets and population. Besides, in 1999-2001 the scheme of "protection" covered also a number of additional expenditures such as procurement of personnel support for military servicemen (1999), state support to coal mines (1999), and social protection for disabled (1999-2001) and orphans (2001).

	1998	1999	2000	2001	2002
Wages of government employees	✓	(incl. arrears of earlier years)	✓	✓	✓
Payroll taxes	✓	(incl. arrears of earlier years)	✓	✓	✓
Purchase of medicines and dressing materials	✓	✓	✓	✓	✓
Provision foodstuffs	✓	✓	✓	✓	✓
Servicing of State debt	✓	cancelled	✓	✓	✓
Transfers to local budgets	✓	✓	✓	✓	✓
Transfers to population	incl. pensions, allowances, scholarships, reimbursement of citizens' savings	Transfers to population related to social protection and social security (pensions, allowances, scholarships, reimbursement of savings)	Transfers to population related to social protection and social security (pensions, allowances, scholarships, reimbursement of savings)	✓	✓
	Protected items are funded as high priority	Protected items are funded as high priority and proportionally to spending units			
		The same is true for spending on:			
		procurement of personnel support for military servicemen, support to coal mines, and social protection for disabled, repayment of arrears of regress claims and one-time aid in case of disability	Social protection of disabled	Social protection of disabled and orphans	

A Graph and Table below contain information on planned and actual amounts of protected items in 1998-2001 and compare their shares with the shares of other, "non-protected" items. As one can see from the Graph and Table, the share of protected items in the overall amount of spending was 66.3% on average in last four years; from 65% in 1998 it increased to 69% in 2001.

Planned Share of "Protected" Items in the Overall Budget Expenditures in 1998-2001 (in percent)



	1998					1999				
	Plan	Actual	% of Annual	% of Total Expenditures		Plan	Actual	% of Annual	% of Total Expenditures	
				Plan	**Actual**				**Plan**	**Actual**
Wages	3,758	3,227	85.9	**15.3**	**18.0**	3,894	3,746	96.2	**15.5**	**17.1**
Payroll taxes	783	653	83.4	**3.2**	**3.6**	783	731	93.4	**3.1**	**3.3**
Medicines and drassing materials	113	45	39.8	**0.5**	**0.3**	137	60	43.4	**0.5**	**0.3**
Foodstuffs	501	377	75.3	**2.0**	**2.1**	471	390	82.9	**1.9**	**1.8**
Servicing of State debt	2,878	2,405	83.6	**11.8**	**13.4**	3,458	3,010	87.0	**13.8**	**13.7**
Transfers to population	5,398	3,017	55.9	**22.0**	**16.8**	4,921	4,151	84.4	**19.6**	**18.9**
Transfers to local budgets	2,502	2,203	88.0	**10.2**	**12.3**	2,426	2,942	121.3	**9.7**	**13.4**
Total protected expenditures	**15,932**	**11,927**	**74.9**	**65.1**	**66.6**	**16,090**	**15,030**	**93.4**	**64.0**	**68.5**
Non-protected" expenditures	8,550	5,985	70.0	**34.9**	**33.4**	9,045	6,917	76.5	**36.0**	**31.5**
Total expenditures	**24,482**	**17,913**	**73.2**	**100**	**100**	**25,135**	**21,947**	**87.3**	**100**	**100**

	2000					2001				
	Plan	Actual	% of Annual	% of Total Expenditures		Plan	Actual	% of Annual	% of Total Expenditures	
				Plan	**Actual**				**Plan**	**Actual**
Wages	5,300	5,576	105.2	**15.6**	**15.7**	6,716	7,531	112.1	**16.0**	**18.6**
Payroll taxes	1,126	1,151	102.2	**3.3**	**3.2**	1,453	1,514	104.2	**3.5**	**3.7**
Medicines and drassing materials	161	164	101.7	**0.5**	**0.5**	434	342	78.9	**1.0**	**0.8**
Foodstuffs	451	485	107.4	**1.3**	**1.4**	628	696	110.9	**1.5**	**1.7**
Servicing of State debt	5,469	4,305	78.7	**16.1**	**12.1**	5,682	3,925	69.1	**13.5**	**9.7**
Transfers to population	6,215	6,204	99.8	**18.3**	**17.5**	7,068	6,171	87.3	**16.8**	**15.3**
Transfers to local budgets	4,028	4,378	108.7	**11.9**	**12.3**	6,989	7,988	114.3	**16.6**	**19.8**
Total protected expenditures	**22,751**	**22,261**	**97.8**	**67.0**	**62.7**	**28,968**	**28,168**	**97.2**	**69.0**	**69.7**
Non-protected" expenditures	11,196	13,271	118.5	**33.0**	**37.3**	13,023	12,239	94.0	**31.0**	**30.3**
Total expenditures	**33,947**	**35,533**	**104.7**	**100**	**100**	**41,991**	**40,407**	**96.2**	**100**	**100**

In addition, the Table suggests that execution of “protected” items has not always been one-hundred percent. However, in all years (except for 2000[5]), financing of these expenditures was closer to the plan than for other budget expenditures. Besides, beginning in 2000 underfinancing of protected expenditures ceased, and each of these expenditures were executed in an amount higher than budgeted (with account for arrears from earlier years).

In the years when funds for protected expenditures were insufficient to cover them in full, the relevant provision of the annual budget law required proportional reduction of expenditures by spending units. Wages of government employees and payroll taxes are expenditure items common for all spending units; thus, they were funded at the highest level compared to other expenditures throughout these years. On the other hand, spending for medicine and foodstuffs was funded less actively.

Among other items, transfers from the State budget to local budgets are the most specific. As one can see from the Table above, as far back as 1998 transfers amounted to only 88 percent of the annual target. Beginning in 1999, however, on an initiative of the Parliamentary Budget Committee, a mechanism of automatic remittance of transfers was implemented in the form of a rate of deductions from national taxes collected on the relevant territory set for each oblast against the amount of

[5] As one can see from the Table, in 2000 the overall figure of underfinancing of expenditure items was attributable to the difference between the actual amount of State debt servicing and the plan for this spending. In 2000, the government managed to fulfil a large-scale restructuring of the foreign commercial debt, which considerably decreased the amount of current liabilities of Ukraine; therefore, actual spending was lower than planned. At the same time, as one can see from the Table, financing of all other items was excellent and even exceeded the planed amounts in some cases.

transfers to be received by this oblast from the State budget. This innovation rapidly and radically improved the situation with financing of budget transfers. Since 2000 transfers to local budgets have been executed in the full amount.

Use of "protected" items in other states

United States of America

Division of expenditure programs into "protected" and "non-protected" (mandatory and discretionary) is an important element of the budgetary system in the USA. This division was implemented in 1990 in the course of a broad and long campaign for improvement of the fiscal discipline and reduction of the federal budget's deficit. The first attempt to achieve this goal was made in 1985 in the form of so-called Gramm-Rudman-Hollings legislation (*Balanced Budget and Emergency Deficit Control Act*) and appeared to be not very successful since this document was focused on trying to control the deficit, while proposing no expenditure planning guidelines required to meet this goal. Because of this, all expenditure programs had to be cut automatically in order to meet the established ceiling of deficit, including those programs, which are currently reckoned as mandatory in the USA. Despite this, the established beacons for the deficit failed to be met. In order to remedy this situation, another legislative act was adopted in 1990 – *Budget Enforcement Act* – which is still in force now with some amendments. This new act, unlike the previous one, implements new approaches to controlling the revenue and expenditure sides of the budget. During the time of its being in force, the budget deficit was reduced and even more rapidly than planned earlier (beginning in 1998 rather than 2002 as was planned, the budget became balanced, and since than an ever greater surplus has been reported). It should be noted, however, that the effect of the *Budget Enforcement Act* coincided with a swift economic growth in the USA; and of course, this fact also positively impacted on the success of the plan to reduce the deficit.

According to the system implemented by this Act, federal outlays are divided into "mandatory (protected) spending" and "discretionary (non-protected) spending." To be more precise, the term "discretionary" implies a possibility to change the opinion or position on certain issues, in this case – on the amount of financing of particular budget outlays. Outlays that are reckoned in the USA as "mandatory" include those expenditure programs that are approved by special legislative acts for a certain period of time (that is, for several years) and cannot be changed (and, most importantly, cut) not only within the fiscal year but also in adopting the Budget Law for each year of the period when the act establishing the expenditure program is in effect. Each year, when formulating and passing the annual budget, the government submits to the Congress for consideration forecasted amounts of "mandatory" expenditures together with calculations underlying these forecasts (such as demographic assumptions). Throughout the period when the Act establishing a "mandatory" outlay remains in effect, neither the government nor the Congress can change the amount of its financing. If a sequestration is needed for any reason, these outlays cannot be cut as well. When passing the annual budget, debates on these programs deal only with those assumptions that underlie the proposed outlays for the next year – the assumptions (and hence, relevant expenditure numbers) can be debated and reviewed.

In parallel with the amounts of "mandatory" outlays, the government submits to the Congress for consideration the ceilings for "discretionary" programs; that is, programs whose amount can be changed both in the process of the budget's adoption and in case the expenditure side of the budget has to be sequestered in the course of its execution. Thus, the division into "mandatory" and "discretionary" programs essentially corresponds to the concept of "protected" and "non-protected" expenditures.

The Table below contains information on the amounts and structure of "mandatory" and "discretionary" outlays in the federal budget of the USA. As on can see, "mandatory", or protected, programs account for more than one half of the overall amount of federal expenditures. In 2002, their share was almost 55 percent, and it is anticipated to increase to almost 58 percent by 2007. Discretional outlays, on the other hand, account for 35.5 percent and are going to shrink to 34.7 percent by 2007.

	Estimate			Change 2002 to 2003		Change 2002 to 2007	
	2002	2003	2007	Amount	Percent	Amount	Annual average
Outlays							
Discretionary							
Defence	336	347	383	11	3,30%	46	2,60%
Nondefence	338	402	439	20	5,20%	57	2,80%
Subtotal, discretionary	718	749	822	31	4,30%	104	2,70%
Emergency response fund	22	19	21	-3	-13,60%	-1	-0,80%
Mandatory:							
Agriculture programs	19	12	9	-7	-37,00%	-10	-13,50%
Medicaid	145	159	219	14	9,60%	74	8,60%
Madicare	223	229	279	6	2,80%	57	4,60%
Federal employee retirement and disability	85	90	106	5	6%	21	4,50%
Unemployment compensation	44	41	41	-4	-8,50%	-4	-1,90%
Social security	456	472	571	16	3,50%	115	4,60%
Other mandatory	131	135	139	4	2,90%	8	1,20%
Subtotal, mandatory	1 102	1 163	1 363	34	3,10%	261	4,30%
Net interest	177	175	160	-2	-1,10%	-17	-2%
Total outlays	2 020	2 080	2 366	60	3,00%	347	3,20%

Source: Explanatory Note to the 2002 US Budget, fiscal volume, "Analytical Guidelines", p. 304, Table 15-6

Canada

In the budget system of Canada, there also exists a notion of protected outlays; however, this instrument is used there only for protection of the amounts of transfers from the federal budget to provincial budgets. Similarly to the USA, the procedure of "protection" and the content of protected outlays (in this case, we are talking about intergovernmental transfers) are defined not in the annual budget law but in a special act. Terminologically, the provision about "protection" of transfer outlays is defined as "guarantee of revenue coverage".

Poland

The main law that regulates the budget system in Poland – the *Law on Public Finance* of 26 November 1998 – also establishes certain procedures for protection of expenditures; this, however, concerns only one expenditure category, namely spending for servicing of the State debt (literally, "State Treasury Debt") (Chapter 3, Article 92, Item 6). According to this provision, spending for debt servicing must be executed as a higher priority compared to other expenditures.